No. 78-1168

In the Supreme Court of the United States

OCTOBER TERM, 1978

MONTE J. WALLACE AND NEIL W. WALLACE,
PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-16a, 19a-20a) is reported at 586 F.2d 241. The opinions of the district court (Pet. App. 1b-7b) and bankruptcy court (Pet. App. 1c-12c) are not reported.

JURISDICTION

The judgment of the court of appeals (Pet. App. 17a-18a) was entered on October 27, 1978. The petition for a writ of certiorari was filed on January 25, 1979. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether a corporate debtor proposing a major recapitalization involving adjustment of the rights of numerous public debentureholders must proceed under Chapter X rather than Chapter XI of the Bankruptcy Act.

STATUTE AND RULE INVOLVED

Relevant provisions of the Bankruptcy Act are set forth at Pet. App. 1d-2d. Rule 11-15 of the Rules of Bankruptcy Procedure is reproduced in the appendix to this brief.

STATEMENT

1. Petitioners own or control 65% of the common stock of respondent Continental Investment Corp. ("CIC") (A. 41, 301).[1] CIC is a holding company that provides diversified financial services through subsidiary corporations (Pet. App. 3a). In fiscal year 1973 CIC suffered serious financial losses (A. 283-287). As a result, CIC defaulted on loan obligations to 16 banks and failed to meet its interest obligations to subordinated public debentureholders (Pet. App. 3a). Following this default, CIC negotiated an agreement with its lending banks, certain debentureholder representatives, and petitioners. That agreement contemplated an overall, extra-judicial restructuring of the corporation's capitalization (A. 395-413). CIC and the banks then entered into an "omnibus refinancing agreement" to implement the restructuring of the company's bank debt (A. 53). Because new securities were to be issued and exchanged in connection with the recapitalization, CIC also filed with the Securities and Exchange Commission a statement needed to register the securities and to solicit proxies from stockholders and waivers and acceptances from debentureholders.[2] CIC stated that if acceptance of the securities to be exchanged in the recapitalization plan could not be obtained from the holders of 95% of the debentures, an arrangement proceeding under Chapter XI of the Bankruptcy Act would be commenced (A. 208).

Less than a week before CIC filed its registration and proxy statement with the Commission, representatives of CIC and other interested parties met with the Commission's reorganization staff and made an oral presentation concerning the planned recapi-

[1] "A." refers to the two-volume appendix filed in the court of appeals.

[2] See Section 5 of the Securities Act of 1933, 15 U.S.C. 77e; Section 14 of the Securities Exchange Act of 1934, 15 U.S.C. 78n; and SEC Rule 14a thereunder, 17 C.F.R. 240.14a-1 *et seq.* CIC's March 19, 1976, prospectus and proxy statement appear at A. 187-394.

talization (A. 523). They expressed the hope that CIC would not have to resort to the bankruptcy court and that a voluntary exchange of securities could be effected (*ibid.*). Failing that, they planned to file a petition under Chapter XI of the Bankruptcy Act (*ibid.*). While the Commission's staff did not state that the Commission would file a motion to transfer such a proceeding to Chapter X, the staff informed the parties of the principle enunciated by this Court in *SEC* v. *American Trailer Rentals Co.*, 379 U.S. 594 (1965), that corporate debtors could not achieve a major adjustment of debt held by public investors in a Chapter XI proceeding (A. 524). The staff also indicated that, while it was premature to consider the question of transfer to Chapter X, it would make its recommendation to the Commission based on whether the public interest would best be served by Chapter X proceedings in the circumstances of the case (A. 525). CIC's own proxy statement and prospectus show that it realized that the Commission might file such a transfer motion (A. 190, 214, 221, 268).

CIC failed to obtain the requisite number of acceptances from its debentureholders, and it filed a petition under Chapter XI to which was attached the earlier recapitalization proposal as a Chapter XI plan of arrangement (A. 1-6). CIC sought to use the acceptances it had obtained from approximately 82% of its debentureholders to obtain confirmation of its plan (Pet. App. 3a). CIC reported in its petition that it had outstanding secured loan obligations

in the amount of $31,288,000; two classes of unsecured debt securities held by more than 1,600 investors in the amount of $45,344,000;[3] miscellaneous liabilities totalling $3,648,000; and 12,944,533 shares of common stock held by 4,100 investors (Pet. App. 3b; A. 4-5).

CIC's plan of arrangement called for a complex restructuring of both issues of publicly-held debentures and a portion of the bank debt (Pet. App. 3b, 5b, 3c).[4] Had the proposed recapitalization been accomplished,[5] CIC would have emerged with a new capital structure consisting of eight layers of securities: Senior Term Notes, Senior Preferred Stock With Warrants Attached, Subordinated Interest-Inclusive Debentures, Junior Preferred Stock With Warrants Attached, Convertible Preferred Stock, and 13 million shares of Common Stock (Pet. App. 3a, 4a, 8a).

2. Pursuant to Section 328 of the Bankruptcy Act, 11 U.S.C. 728, and Rule 11-15(b) of the

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[3] These debt securities included $1,511,000 in 9% convertible subordinated debentures due 1990 and $37,158,900 in 9% subordinated debentures due 1985 (Pet. App. 3b). The accrued interest obligation on these securities was approximately $6,960,000 at the time the petition was filed.

[4] Under the omnibus refinancing agreement, the bank creditors previously had agreed to purchase a CIC subsidiary, thus reducing the bank indebtedness to $27,000,000 (Pet. App. 3b, 3c).

[5] Acceptance of the arrangement by a majority (in number and amount) of each creditor class would have resulted in confirmation and thus bound all members of the class. See Section 362 of Chapter XI, 11 U.S.C. 762.

Rules of Bankruptcy Procedure, the Commission filed a timely motion to transfer the case to Chapter X (Pet. App. 4a). The bankruptcy court denied the Commission's transfer motion, even though it found that "it is unlikely that any arrangement or reorganization could be accomplished without materially modifying [CIC's] publicly held indebtedness" (Pet. App. 6c). The district court reversed, holding that *SEC* v. *American Trailer Rentals Co., supra*, required the case to proceed under Chapter X because it did "not fall within the exceptions to the general rule that proceedings for adjustment of publicly held debt should appropriately be in Chapter X" (Pet. App. 7b).

The court of appeals affirmed the district court, pointing out that:

> [a]ll parties concede that the reorganization proposed in this case is major, greatly altering the rights of numerous widespread public investors. Therefore, this corporate rehabilitation, if it is to go forward at all, must proceed in Chapter X. It is the exact kind of case for which Congress intended Chapter X.

Pet. App. 8a; footnote omitted. The court of appeals observed that this Court's opinion in *America Trailer Rentals* "stated in no uncertain terms that major reorganizations of publicly held debt where the investors are many and widespread must proceed in Chapter X" (Pet. App. 16a, 20a).

ARGUMENT

The decision of the court of appeals, on which we generally rely, is in accordance with principles long established by this Court and does not conflict with any decision of another circuit. Review by this Court is unwarranted.

1. This Court has repeatedly pointed out that Chapters X and XI, added to the Bankruptcy Act in 1938, are designed to serve fundamentally different purposes.[6] The two chapters " 'were specifically devised to afford different procedures, the one [Chapter X] adapted to the reorganization of corporations with complicated debt structures and many stockholders, the other [Chapter XI] to composition of debts of small individual businesses and corporations with few stockholders * * *.' " *SEC* v. *American Trailer Rentals Co.*, 379 U.S. 594, 608 (1965), quoting from *SEC* v. *United States Realty & Improvement Co.*, 310 U.S. 434, 447 (1940). Where major recapitalizations are required, Chapter X provides administrative safeguards essential to the protection of public investors:

> The aims of Chapter X * * * were to afford greater protection to creditors and stockholders

[6] The Bankruptcy Act has been greatly revised and recodified by Pub. L. No. 95-598, 92 Stat. 2549. Section 403(a) of the new Act provides that the old law applies to all cases commenced before October 1, 1979 (92 Stat. 2683). The new Act thus provides no support to petitioners; the enactment of a new code for bankruptcy cases suggests, to the contrary, that review by this Court of cases under the old statute is unnecessary. See page 12, *infra*.

> by providing greater judicial control over the entire proceedings and impartial and expert administrative assistance * * * through appointment of a disinterested trustee and the active participation of the SEC.

379 U.S. at 604. The trustee appointed under Chapter X must make a thorough examination of the debtor's financial condition, transmit his independent report to creditors and stockholders, and formulate a reorganization plan to be commented on by the Commission, approved by the district court, and voted on by all affected parties in interest. *Ibid.*

The contrast between the provisions of Chapter X and Chapter XI is marked. Under Chapter XI, formulation of the plan of arrangement rests primarily with the debtor. "There are no provisions for an independent study by the court or a trustee, or for advice by them being given to creditors in advance of the acceptance of the arrangement." *SEC* v. *American Trailer Rentals Co., supra,* 379 U.S. at 606. Chapter XI "sacrifices to speed and economy every safeguard, in the interest of thoroughness and disinterestedness, provided in Chapter X." *SEC* v. *United States Realty & Improvement Co., supra,* 310 U.S. at 450-451.

In light of the limited purpose of Chapter XI to "provide a quick and economical means of facilitating simple compositions among general creditors" (*SEC* v. *American Trailer Rentals Co., supra,* 379 U.S. at 606), this Court has emphasized that "as a general rule Chapter X is the appropriate proceeding for

adjustment of publicly held debt" (*id.* at 613).[7] Exceptions to this general rule are narrowly defined (*id.* at 614):

> *General Stores* [*Corp.* v. *Schlensky,* 350 U.S. 462 (1956)] indicates the narrow limits within which there are exceptions to this general rule that the rights of public investor creditors are to be adjusted only under Chapter X. "Simple" compositions are still to be effected under Chapter XI. Such a situation, even where public debt is directly affected may exist, for example, where the public investors are few in number and familiar with the operations of the debtor, or where, although the public investors are greater in number, the adjustment of their debt is relatively minor, consisting, for example, of a short extension of time for payment.

There is no dispute that the plan proposed in this case is not a simple composition. Thousands of public investors would be affected by a complex scheme of reorganization, totally revising the capital structure of the corporation (see Pet. App. 8a). As the Court said in *SEC* v. *American Trailer Rentals Co., supra,* 379 U.S. at 615:

> Here public debts are being adjusted. The investors are many and widespread, not few in number intimately connected with the debtor,

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[7] The Court noted in *American Trailer Rentals* (*ibid.*) that it was reaffirming the principle of *SEC* v. *Canandaigua Enterprises Corp.,* 339 F.2d 14 (2d Cir. 1964), which held that "the need for a readjustment of publicly held debt creates a presumption in favor of Chapter X * * *." 339 F.2d at 19.

and the adjustment is quite major and certainly not minor. These facts alone would require Chapter X proceedings under the above-stated principles.

In simple terms, the "needs to be served" in a proceeding of this nature require resort to the provisions of Chapter X. See *General Stores Corp.* v. *Shlensky*, 350 U.S. 462, 466 (1956); Pet. App. 8a-9a.[8]

Petitioners nonetheless contend (Pet. 9) that the expense and delay resulting from compliance with Chapter X must be considered. Although it observed that this Court has determined that such factors are not relevant where a complex recapitalization is undertaken (*SEC* v. *American Trailer Rentals Co.*, *supra*, 379 U.S. at 617-618), the court of appeals concluded that there is little danger of unnecessary delay and expense. Chapter X is "flexible," and if it is in fact consistent with the interests of public investors, the plan negotiated by CIC should receive "expedited" consideration (Pet. App. 16a). This finding is a sufficient answer to petitioners' argument.[9]

[8] It would be anomalous to permit the issuance of eight layers of new securities in a Chapter XI proceeding designed for "simple compositions." Even with the numerous procedural safeguards prescribed under Chapter X to assure that the plan is analyzed by an independent trustee and clearly presented to investors, "the substitution of a simple, conservative capital structure for a highly complicated one may be a primary requirement of any reorganization plan." *Consolidated Rock Products Co.* v. *Du Bois*, 312 U.S. 510, 531 (1941).

[9] Contrary to petitioners' assertion (Pet. 15), the Commission has not "usurped" the judiciary's role by moving for a transfer in this case. Under the Bankruptcy Act and rules thereunder, the Commission or any party in interest may move for a transfer. The decision whether to transfer is a judicial decision, guided by the principles enunciated by this Court. See *SEC* v. *American Trailer Rentals Co.*, *supra*, 379 U.S. at 619-620.

2. Contrary to the assertion of petitioners (Pet. 13-14), the decision below does not conflict with that of any other circuit. *In re Penn Central Transportation Co.*, No. 78-1715 (3d Cir. Jan. 11, 1979), approved a railroad reorganization under Section 77 of the Bankruptcy Act and an arrangement of the debt of the railroad's parent under Chapter XI. The debt arranged in the Chapter XI proceeding was not publicly held debt; the petition of the debtor disclosed that approximately 70 banks and financial institutions were the holders of the indebtedness. There was thus no need to protect debt holders under Chapter X. Moreover, while the proceeding under Section 77 was complex (slip op. 10), the proceeding under Chapter XI simply involved the exchange of debt securities for common stock. In these circumstances, expedited procedures were appropriate under Chapter XI.[10] Similarly, in *In re Alrac Corp.*, 550 F.2d 1314 (2d Cir. 1977), the Chapter XI plan provided for a relatively simple adjustment: "Full payment of the principal on Alrac notes and debentures has been

[10] The Third Circuit stated that proceedings under Chapter X would not be preferable in these circumstances, pointing out that "no absolute rule" governs whether rehabilitation should proceed under Chapter X (slip op. 22 n.10). The court of appeals here also recognized that there is no absolute rule (Pet. App. 6a-7a).

provided for and the adjustment affected only the timing of the payments and the note holders' right to interest after August 20, 1974." *Id.* at 1319. As the court of appeals here pointed out, the present reorganization "is far more pervasive than that in *Alrac*" (Pet. App. 13a).

3. In any event, the decision in the case is of little future importance. On November 6, 1978, Congress enacted a new Bankruptcy Act, Pub. L. No. 95-598, 92 Stat. 2549. The Act prescribes one consolidated business rehabilitation chapter in place of Chapters X and XI of the present Act. See 92 Stat. 2625. Thus, with respect to petitions filed after the effective date of the new statute (October 1, 1979), there will be no occasion for the lower courts to decide whether to transfer proceedings. There is no reason for this Court to review a case under the old statute.[11]

It is true that under Section 1104(a) of the new Act, 92 Stat. 2627, questions of interpretation will arise regarding the circumstances under which a reorganization trustee need be appointed. However, contrary to the assertion of petitioners (Pet. 18-19), those questions should be resolved in the future under the terms and policies of the new statute, and the holding of the court below should have no controlling effect.

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[11] As CIC's counsel stated in the court of appeals, the creation of a unified reorganization procedure means that "a dispute such as that involved in these appeals will not arise in the future" (Pet. App. 1g-2g).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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MARCH 1979

APPENDIX

RULES OF BANKRUPTCY PROCEDURE

Rule 11-15

CONVERSION TO CHAPTER X

(a) Motion by Debtor. A debtor eligible for relief under Chapter X of the Act may, at any time, make a motion to have the case proceed under such Chapter.

(b) Motion by Party in Interest Other Than Debtor. At any time until 120 days after the first date set for the first meeting of creditors in the Chapter XI case, a motion may be made by the Securities and Exchange Commission or other party in interest to have the case proceed under Chapter X of the Act. The court may, for cause shown, extend the time for making such motion.

(c) Form of Motion; Answer. A motion made under this rule shall state why relief under Chapter XI of the Act would not be adequate and shall also conform substantially to Official Form No. 10-1. * * *

(d) Hearing and Order. After hearing, on notice to the debtor, the Securities and Exchange Commission, indenture trustees, creditors, and stockholders, and such other persons as the court may direct, the court shall, if it finds that the case may properly proceed under Chapter X of the Act, grant the motion and order that the case proceed under that Chapter. The granting of the motion shall be deemed to constitute approval of a petition under Chapter X.

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